Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Burton | Analyst: Roger Lackey | Bill Number: SB 1038

Related Bills: See Legislative History | Telephone: 845-3627 | Amended Date: 02-18-00

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Exemption/Alien Corporation Qualifying Investment Stock Or Security Income/Doesn't Apply To Corporations

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

_____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO _____.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____ STILL APPLIES.

X OTHER - See comments below.

SUMMARY OF BILL

Under the Bank and Corporation Tax Law (B&CTL), this bill would provide that income or gain or loss from stocks or securities would not be treated as income derived from California sources where such income is received by an alien corporation, as defined, whose sole activity in this state is from trading stocks or securities for its own account, as defined under federal law. Furthermore, such an alien corporation would not be considered to be doing business in California for tax purposes.

This analysis will not address the bill's provision relating to the cigarette tax, as it does not impact state income tax revenue or the department's programs and operations.

SUMMARY OF AMENDMENT

The February 18, 2000, amendment eliminated the language in the bill that would have added the state Treasurer and a public member to the Franchise Tax Board (FTB) and would have provided that the FTB Chair be selected on a rotating basis.

The department did not analyze the bill as it was amended September 10, 1999. Because the bill was amended late in the legislative session, there was insufficient time to complete an analysis.

Prior to September 10, 1999, SB 1038 did not impact the department and had not been analyzed.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Alan Hunter for GHG	3/13/00
_____ N	_____ OUA	X PENDING		

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would go into effect immediately upon signature. However, the provision relating to the sourcing of income from stock and securities specifies that it would apply to income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 1239 (1999/2000), would provide that income, gain or loss from stocks or securities received by an alien corporation, as defined, that trades stocks or securities for its own account, as defined under federal law, would not be treated as income derived from or attributable to California sources.

SPECIFIC FINDINGS

Under federal law, a foreign corporation (for California purposes a foreign corporation is referred to as an “alien corporation”) that is engaged in a trade or business within the United States is subject to U.S. taxation on its net income that is effectively connected with the conduct of that trade or business within the U.S.

Under a “safe harbor” exception to the "engaged in a United States trade or business rule," foreign persons (both foreign individuals and alien business entities) that trade in stocks or securities for their own account are not treated as engaged in an U.S. trade or business. This exception covers trading in stocks, securities, and options to buy or sell stocks or securities.

For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stock or securities. For tax years beginning before January 1, 1998, if the principal business of the foreign corporation is trading in stocks or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is in the United States.

In general, **California law** taxes California residents on income from all sources. Nonresidents of California are subject to tax on all income derived from sources within this state. California has unique rules relating to nonresidents that do not conform to any federal nonresident alien rules.

For nonresident qualifying investment partnerships, as defined**, current state law** provides that California source income earned from interest, dividends, or gains or losses from qualifying investment securities is not considered to be derived from California sources. Consequently, such income is not subject to the California income tax. This exclusion from income derived from a California source applies regardless of whether the partnership has a usual place of business in this state.

An investment partnership is one that has at least 90% of its partnership’s costs of its total assets invested in qualifying securities, deposits at banks or other financial institutions, and office space and equipment reasonable to carry on its activities. It also can derive no less than 90% of its gross income from interest, dividends, and gains from the sale or exchange of qualifying investment securities. An interest in a partnership is not a qualified investment security unless the partnership is an investment partnership.

Qualifying investment securities include: common stock, including preferred stock or debt securities convertible into common stock, and preferred stock; bonds, debentures, and other debt securities; foreign and domestic currency deposits and securities convertible into foreign securities; mortgage-or asset-backed securities secured by governmental agencies; repurchase agreements and loan participations; foreign currency exchange contracts and forward and futures contracts on foreign currencies; stock and bond index securities and futures contracts, and other similar financial securities and futures contracts on those securities; regulated futures contracts; and options to purchase and sell any of the preceding qualified investment securities, except regulated futures contracts.

Current **state law** limits those entities that can be considered investment partners to the following specified nonresident taxpayers:

- an individual whose only contact with the state, with respect to qualified investment securities, is through a California broker, dealer or investment adviser;
- a partner, including a bank or corporation, in an investment partnership;
- the beneficiary of a qualifying estate or trust whose investment account is managed by a corporate fiduciary located in the state; or
- a unit holder in a regulated investment company.

The exclusion from income does not apply if the investments are interrelated with any other business activity of the nonresident that is distinct and separate from the investment activity and is conducted by the nonresident in California, or if the investments are acquired with the working capital of a California trade or business. A bank or corporation is not allowed to exclude the income if it participates in the management of the investment activities or is engaged in a unitary business with another taxpayer that participates in managing the investment activities or has income from California sources.

For corporations**, existing state law** provides that every corporation that is incorporated in California or incorporated in another jurisdiction but qualified to do business in California is subject to the minimum franchise tax. Moreover, every corporation that is "doing business" in California is subject to the **corporation franchise tax**. "Doing business" is defined as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. The franchise tax is not a tax on income. Rather, the franchise tax is a tax, measured by net income, for the privilege of doing business in the state. The corporate franchise tax rate is 8.84% of net income, or the $800 minimum franchise tax, whichever is greater.

For foreign corporations (alien corporations for California tax purposes), California **state law** does not generally conform to the U.S. income sourcing rules discussed above in the federal law portion of this analysis. However, for California purposes, corporate taxpayers that have a water's-edge election in force are required to use federal rules to determine U.S. source income, including rules for foreign corporations. **Existing state law** requires corporations with activities both inside and outside California to combine all activities when determining business income apportionable to the state for tax purposes.

Under **existing state law,** if a corporation is “doing business” in this state, all or part of its income may be taxed by California. The portion of a corporation’s income taxable by California is determined by an apportionment formula. Generally, the amount of income that may be apportioned to California for tax purposes includes income received while engaged in activities in this state and income received from merchandise orders that resulted from those activities in this state.

Alternatively, **existing state law** provides that corporations not organized or qualified to do business in California, but that derive income from California sources and are not “doing business” in California, are subject to the **corporation income tax**.

This bill would provide that income, gain or loss from stocks or securities received by an alien corporation, as defined, that trades stocks or securities for its own account, as defined under federal law, would not be treated as income derived from or attributable to California sources.

This bill would specify that an “alien corporation” trading stocks or securities for its own account is not “doing business” in this state and consequently is not subject to the minimum franchise tax or corporation franchise tax.

This bill also would specify that a dealer in securities would not be allowed this exclusion.

For purposes of this bill:

“Alien corporation” means a corporation organized under the laws of a country, or political subdivision thereof, other than the United States.

“Dealer in securities” means a dealer in stocks or securities as defined under the Internal Revenue Code.

These sourcing rules would not apply to an alien corporation that itself has or that is engaged in a unitary business with another corporation that has income derived from or attributable to California sources other than the "trading for their own account in stock or securities" income added by this bill.

Policy Considerations

This bill would essentially conform California law to federal law with respect to alien corporations trading for their own account and would provide treatment for alien corporations similar to the treatment allowed to California investment partnerships.

This bill could be interpreted to provide an advantage to alien corporations relative to corporations organized in other states of the United States contrary to federal constitutional limitations on discriminatory state taxation of interstate commerce.

Implementation Considerations

This bill would specify that it applies to income years beginning on or after January 1, 1999. However, since the bill cannot become law until 2000, a retroactive implementation date may create difficulties for the department. It also might be construed to be an unauthorized gift of public

funds. These concerns would be eliminated if the bill were amended to provide an operative date of January 1, 2000.

FISCAL IMPACT

Departmental Costs

This bill is not expected to result in significant costs to the department.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in negligible revenue effects in any given year beginning in 2000-01. Alien mutual funds (those incorporated under laws of foreign countries) are not currently managed from California since management from California could result in California taxation. Without this bill to clarify the pass-through nature of such a fund organized in corporate form, these funds would probably never be managed from California because the possibility of California taxation.

The bill would be operative for income years beginning on or after January 1, 1999, with enactment assumed after June 30, 2000.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of foreign mutual funds that would be actively managed from California and the extent of each company’s factor presence in the state would determine the revenue impact of this bill. To the extent these funds establish nexus in California, their limited factor presence would determine the level of taxation. Under these circumstances, the tax effect would be a minimum tax of $800 multiplied by the number of such foreign corporations.

Federal estimates in the Taxpayer Relief Act of 1997 for the provision allowing foreign mutual funds to be managed in the United States, were negligible, less than $500,000 annually.

BOARD POSITION

Pending.